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Policyholder's service bureau.
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EFFECTIVE CREDIT MANAGEMENT

A Report of Policies and Practices Employed by Manufacturers and Wholesalers

POLICYHOLDERS SERVICE BUREAU
METROPOLITAN LIFE INSURANCE COMPANY
HOME OFFICE—NEW YORK
Pacific Coast Head Office—San Francisco
Canadian Head Office—Ottawa

Effective Credit Management

A Report of Policies and Practices Employed by Manufacturers and Wholesalers

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Business

A SERVICE TO BUSINESS IN THE INTEREST OF 27,000,000 PEOPLE

THIS is one of many publications issued by the Policyholders Service Bureau in the interest of better management in business. The Metropolitan has good reason for desiring to contribute to improved practice in management. It is because this has a direct bearing on the economic well-being of its policyholders. More than one person in every five of the general population—an average of about one in every family—is a Metropolitan policyholder. An even greater proportion of employees in commerce and industry are insured by the Company.

Because of its great stake in the Nation's economic life, the Company maintains the Policyholders Service Bureau to carry out a program of economic services to business. The Bureau staff is made up of specialists in the various fields of management—in business organization; office management; accounting and finance; in marketing, distribution, advertising and sales management; in production and personnel management; in business and economic research; in industrial health and accident prevention.

Under the direction of these specialists, investigations of subjects of current interest to business executives are being conducted continuously. The results of those investigations which are of general interest are published from time to time. A complete list of several hundred reports issued by the Bureau and available for distribution is given in the *Index of Economic Reports*. Copies of this may be secured on request. Address:

POLICYHOLDERS SERVICE BUREAU
METROPOLITAN LIFE INSURANCE COMPANY
ONE MADISON AVENUE, NEW YORK, N. Y.

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Teachers College
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Foreword

NUMEROUS INQUIRIES have been received and investigations have been conducted by the Policyholders Service Bureau on certain problems of industrial credit management. In the course of these investigations, information has been collected on credit and collection policies and practices actually in effect in a number of companies identified with various industries. This report presents much of the information assembled in this way. It does not represent the results of any one investigation, but the accumulated results of several, each of which was concerned with one specific phase of the subject of credit management.

In bringing this material together in this form, it is not the Bureau's intention to present a comprehensive and all-inclusive study of the subject, but rather to outline some of the credit and collection policies and practices which have been used effectively by manufacturers and wholesalers. This information is set forth in factual form with the thought that the methods described may be of value to business men, particularly during the present period of business depression when credit and collection problems are acute.

Grateful appreciation is due those whose experience contributed so largely to this report.

Effective Credit Management

WHY A CREDIT SERVICE?

CREDIT MANAGEMENT has an important place in business as conducted today. A large percentage of all business transactions involve a time interval between the date of shipment or performance of an order and the date of actual payment. It is because of this interval, during which time the vendor actually is financing the transaction, that the necessity for a credit service has developed. There are a number of aspects to this service, including the investigation or appraisal of the credit risk; the determination of limits within which credit safely may be granted; the fixing of the terms of payment; and the ultimate collection of the account. Whatever the specific credit problem, however, some provision must be made, either formally or informally, in the average business organization to carry out the function of credit management.

From the standpoint of the manner in which this credit service has been interpreted and developed, the companies included in this investigation are of two kinds. One group includes those companies which have established credit activities as an important function of their business, usually under the direction of a specialist in credit management. The second group includes those companies that have placed less emphasis on the credit service to be rendered and construe it as merely an incidental phase of the sales program. The latter concerns tend to rely largely on available credit agencies and published material for credit decisions.

The importance of credit management and the relative position it occupies in the industrial organization is affected, of course, by the size of the organization. The type of business also has an important bearing on the manner in which the credit service is conducted in individual companies. For example, one company, engaged in the manufacture of cotton thread, sells a large part of its production to small dry goods stores for ordinary household use. This company has many customers, widely scattered throughout the country. The frequency and number of orders handled are great, but the amount of money involved in the average order and in the average customer's account is relatively small. This company has organized its credit activities in such a way that orders would be handled expeditiously but in a somewhat routine manner.

The situation in the case of a manufacturer of special order machinery is somewhat different. Here the orders and customers are much less numerous than in the other example, but each order represents an important capital investment by the manufacturer. Moreover, as each piece of machinery must be made to the customer's individual specifications and as a period of weeks generally elapses before shipment can be made, there is not the same need for an immediate credit decision. In this case, each order receives the individual attention of the major credit executive of the company.

Although every business concern does not maintain a separate credit and collection department, many of those interviewed in the course of this investigation testified to the fact that actual financial benefits will accrue from the careful supervision of credits and the energetic follow-up of collections. It is the opinion of many that the best results along these lines have been secured if a well qualified credit executive is employed, or if some one individual in the organization is assigned definite and primary responsibility for credit functions.

The possibility of actual financial benefits through better credit management is illustrated by the case of a company engaged in the manufacture of chemicals. This organization's annual sales amounted to approximately $1,300,000 and its accounts outstanding averaged about 40 per cent of annual sales. It was operating without a definitely established credit policy and without a qualified credit executive. That the ratio of outstanding accounts receivable to sales was high for the industry was indicated by the fact that an independent investigation conducted among twenty-one competitive companies operating in the same field under comparable conditions disclosed a composite ratio of outstanding accounts to sales of about 29 per cent. In the course of this manufacturer's investigation of the advisability of a change of policy in regard to credit matters, it was pointed out that a reduction in the average ratio of the outstanding accounts in this case from 40 per cent to 30 per cent of annual sales through a more stringent credit policy would equal $130,000 on one year's sales. In other words, through a reduction of $130,000 in the average amount of capital tied up in uncollected accounts throughout the year, this amount would be released for other investments. Assuming an interest charge of 6 per cent on this amount, it was estimated an annual saving of $7,800 would result from this item alone.

GENERAL CREDIT POLICIES IN FORCE

Most companies that were canvassed on this point make an effort to conduct their business in accordance with definitely established credit policies. A summary of the fundamental principles and practices underlying these policies among these companies would include the following:

1. To accept every credit risk strictly on the basis of character, capacity, and capital, commonly referred to as the "three C's," with particular emphasis on character.
2. To size up, approximately, each customer's probable stock and the normal credit requirements in each line.
3. To show special consideration in connection with initial orders so as to cultivate the customer's goodwill and win his confidence, which is considered essential in any sound credit transaction.
4. In troublesome cases or cases of temporary financial embarrassment, to render special assistance through leniency, and special service through financial counsel, whenever necessary, with the aim of helping the customer to regain his credit standing with the trade, and thus further cement existing friendly relations.
5. To obtain a satisfactory turnover of accounts receivable without needlessly antagonizing a customer.
6. Finally, to devise a policy sufficiently flexible to permit the handling of each individual account on its merits, to build up a feeling of confidence on the part of the customer, and to employ the confidence thus gained in the fostering of better mutual relations.

Many executives have stressed the importance of maintaining a spirit of cooperation and coordination between the sales and credit departments. In one company this is accomplished by having the heads of these two departments go over the daily orders once or twice a week and decide the unusual cases together. In addition, salesmen are encouraged to discuss the conditions of their customers with the credit manager at every opportunity.

INVESTIGATING CREDITS AND SOURCES OF INFORMATION

Credit investigations among the companies in which this point was studied adhere closely to a review of the three basic credit factors, character, capacity and capital. The methods used to ascertain these facts differ somewhat with individual manufacturers.

Use of Credit Agencies

The majority of companies reporting depend to a considerable extent on the facilities of the leading mercantile and the various special credit reporting agencies for this type of information. The service furnished by these agencies consists, primarily, of reporting the antecedents, or business history, of a credit risk as well as the latter's ability to pay. These organizations render a valuable service on a nation-wide basis to all types of business establishments. There are, also, a number of special agencies which differ from the general type of mercantile agency in that they serve either a single trade or a limited number of trades, or cover a limited territory; and furnish information, based on actual ledger experience, as to the customer's payment record. The information furnished by some of the outstanding agencies generally is presented in the form of a report outlining the business history of the account, and usually includes a financial statement which these agencies try to secure every year.

In addition to the credit reporting agencies that supply information primarily along character lines, there are trade credit bureaus specializing in reporting actual ledger experiences—that is, the manner in which an account meets its obligations. Such informa-

REPORT ON:

BLANK NAME BLANK ADDRESS DEC. 22, 1931

BUSINESS OR SUB. NO	HOW LONG SOLD	DATE OF LAST SALE	HIGHEST CREDIT	AMOUNT OWING	AMOUNT PAST DUE	UNFILLED OR FIRST ORDERS	TERMS OF SALE	MANNER OF PAYMENT: DISCOUNTS	MANNER OF PAYMENT: PAYS WHEN DUE	MANNER OF PAYMENT: DAYS SLOW	COMMENTS
NEW	YORK										
1217	-203										
#2-120						270	2-10-30				
3-9	yrs	11-31	202	121	92		2-10-30			19-40	
3-14	3yrs	10-31	25				2-10-30			15	
3-20	yrs	12-31	122	95		45	30			20	
3-26	yrs	12-31	11000	2000			reg	takes		unearned	50-at times. discounts.
3-28	s yrs	12-31	15000	13000			2-10	x			
3-39	yrs	12-31	395	78			2-10-30			25-35	
3-92	4-31	4-31	21				2-10-30			30	
3-113	yrs	12-31	264	264	120		2-10-30			30	
3-115	yrs	12-31	182	65			2-10-30		x		
3-170	3-23	12-31	473	27			2-10-30			32	
3-251	7-29	9-31	615	71	71		2-10-30	x			
				15721	283	315					

Figure 1

tion tells not only whether an account is prompt, discounts, or is past due, but in some cases also reveals whether an account is overbuying or is buying outside its regular market —important points that frequently serve as danger signals in the evaluation of a credit risk. The form of report used by one of the organizations in this field is illustrated as Figure I on Page 7.

Some of the special agencies render what is known as a "credit checking service," which is useful particularly to small manufacturing establishments not in a position to maintain a separate credit department with a credit manager in charge. Through this service, the agency checks the risk for the subscriber, recommending whether or not a given order should be accepted and shipment made on a credit basis. During the course of this investigation a number of manufacturers were found, particularly in the cutting up trade of the textile field, who depend exclusively on the credit checking services of these special agencies reporting ledger experience. This method, one credit executive pointed out, has this disadvantage: the agency, because of anxiety to be on the safe side, may report unfavorably on many a questionable risk that, at times, might develop into a good risk through intelligent handling by a qualified credit man.

According to the information furnished in this study, one point generally considered by credit executives gauging the relative values of special agencies, is the range of commodities they cover. While some agencies may furnish reliable information for one line of business, this information, while undoubtedly valuable as far as it goes, may have to be supplemented at times by data from other agencies reporting on a wider range.

Trade Group Meetings

An interesting angle of the credit investigation work in large cities is the development of what may be designated as discussion groups among credit executives in various lines of business. These groups are sponsored generally by trade associations and meet at stated intervals for the purpose of discussing doubtful accounts concerning which unfavorable information may have been received, new accounts which have placed an initial order with one of the members, or other topics that may be of interest to the group as a whole. Extremely valuable and especially up-to-date information, not otherwise available, is reported to be exchanged by the credit executives regularly attending these trade group meetings.

Salesmen as Credit Reporters

Salesmen frequently are used to good advantage as a source of credit information for both new and existing accounts. Often they are in a position to secure much valuable information locally. For this purpose, many organizations have provided a form for salesmen's credit reports on which provision is made for the collection of details necessary for sound checking of credit. The information usually included on such reports varies. In some cases covered by this survey, extremely detailed reports are required in which considerable personal information concerning the individual in question is reported. This information may touch upon personal habits, other business connections, local reputation, business ability, etc. However, the information that is included on most of the reports reviewed is along the lines of—

1. The form of organization (*whether operating as an individual, partnership or corporation*),
2. Kind of business,
3. Type of competition,
4. Character of trade served,
5. Liability as endorser or bondsman,
6. Extent of insurance,
7. Banking connections,
8. Local business conditions,
9. Local credit reputation, and
10. General impression.

In addition, the customer usually is required to furnish a number of trade and bank references.

Best results are reported to be secured in those cases in which complete credit information is obtained by the salesman at the time of his call on the customer. It has been found helpful to have such information verified by local banks or other agencies whenever possible.

The form of salesman's credit report employed by a prominent oil company is illustrated by Figure II below.

Personal Interview

Many of the credit executives interviewed recommend personal interviews with the applicant for credit—if conditions permit—as one of the most satisfactory methods for safeguarding credits and, at the same time, for conserving and fostering the customer's goodwill. This method is used effectively in the dress manufacturing field. The majority of the manufacturers in this industry are located in the New York area and, as most of the retailers make at least one visit to the New York market each season, there are frequent opportunities for such personal interviews.

Trade Publications

Trade publications in the various industries and in the mercantile fields also are used effectively as additional sources of credit information. These publications carry many incidental news items about individuals and organizations in their respective trades which frequently are considered of great value to the credit department. Many executives make a practice of clipping such items and filing them for future reference.

SALESMAN'S REPORT ON NEW CUSTOMER.

Name .....(Corporation ( )
(Partnership ( )
Address .....(Proprietorship ( )

Officers, Partners or Proprietor: .....

Credit Desired: Gas: $.....Terms: .....
Oil: $.....Terms: .....

Wherever amount of credit involves $500.00 or more, irrespective of terms requested, property statement, supply of which you already have, should be properly filled out and signed by the customer and accompany this report.

Banks with: .....

Now buying from: (Include names obtained through observation or furnished on request.)

Name	Address
.....	.....
.....	.....
.....	.....

ANY IMPRESSIONS OF VALUE, INCLUDING YOUR PERSONAL RECOMMENDATIONS:

.....	.....
.....	.....
.....	.....
.....	.....

Did you arrange for shipment of initial order on C.O.D. basis, pending credit investigation, so as to avoid unnecessary delay?.....

Date..... Signed.....
Salesman.

Initial contract, agreement or order will not be considered unless accompanied by this report properly filled out.

FIGURE II

ANALYZING FINANCIAL STATEMENTS

THERE IS some variation among individual companies in the extent to which financial statements are used in connection with the extension of credit. Some companies base their actions strictly on the information furnished by the various agencies rendering

credit checking services and make no attempt at statement analysis. Others limit this activity to a review of the statements submitted with the reports of the large mercantile rating agencies. However, many companies have made it a practice to require all customers to submit a current financial statement, signed by a partner or an official of the company, at least once a year. This was found to be the practice particularly among those companies which have set up their credit activities under a separate department. More recently, it appears that in many cases manufacturers are requiring such statements semi-annually and even quarterly when the occasion warrants.

Some executives report that their experience has shown that more detailed financial statements often can be obtained direct from customers, than from the regularly published data. In the opinion of one manufacturer, this is due to the fact that a credit applicant is willing to furnish a more detailed statement to a prospective creditor than to an agency for circulation in a rating book.

The form of the statements used for credit analysis generally conforms to that developed and recommended by some of the leading associations in the credit field, such as the National Association of Credit Men. A copy of the financial statement form developed by this association is reproduced as Figure III on page 12. In addition to the items generally found on a balance sheet, this form provides space at the bottom for reporting other information, of which the two items of annual sales and expenses are considered most important from a credit point of view, since a satisfactory analysis of the financial condition of a customer would be difficult without them.

A carefully prepared financial statement may be made to reflect numerous important facts not otherwise available to the credit executive. Among the more important facts generally singled out for analysis by some of the credit executives interviewed are the customer's current liquidity, the relationship of the two profit and loss items (sales and expenses), and the stock and accounts receivable turnover.

As a means of providing a convenient work sheet for statement analysis purposes, a large silk manufacturer has developed a standard form to which the financial data for each customer are transferred from the original statement submitted by the customer. This form provides spaces for each of the balance sheet and profit and loss items in which the manufacturer is most interested and a section is provided, labeled "Comments," in which the results of the analysis are entered. The form used is illustrated in Figure IV on page 13. This company requires its customers to submit a financial statement at least every six months, so that the credit file for any one account will reveal a series of these work sheets for comparison.

Example of Statement Analysis

A typical example of the method followed in analyzing a financial statement for purposes of credit appraisal was contributed to this survey by the credit manager of a dress manufacturing company. The case selected for analysis was that of a retail dry goods store to which this company sells. For the sake of simplicity, minor details have been omitted in order to bring out more clearly the items that this executive considers the most important. The conditions, as reflected in the statement on page 11 are assumed to be as of December 1st, for purposes of illustration. The amounts are fictitious.

From the standpoint of credit appraisal, this statement was interpreted by the manufacturer's credit executive as follows:

> Generally speaking, this account would be closely bordering on a poor credit risk because of its comparatively low ratio of current assets to current liabilities, the true status of which can be appraised only after a careful analysis and after a considerable "shaving down" of the accounts receivable and inventory items.
>
> First of all, it would be particularly important to know if this customer's line of credit with the bank is on a secured or unsecured basis, for any downward change of his present financial condition would probably result in the recall of his bank credit, which would make it virtually impossible for him to meet his other obligations.
>
> His annual total sales are $700,000, or approximately $58,000 per month. When making an allowance for slow accounts, this figure can be trimmed down to at least $50,000. His total annual expenses amount to $215,000, or, roughly, $18,000 per month. The accounts receivable item amounting to $90,000, if divided by the $50,000, the total monthly sales just computed, will show his accounts receivable turnover as on a fifty-five days' basis, or approximately six and one-half times a year.
>
> His stock turn is roughly ascertained by dividing his inventory into his total annual sales, after the latter item has first been reduced to a cost basis, since the inventory item is figured at cost. Allowing about a 30 per cent gross profit, his stock turn would then be about six and one-half times a year, indicating that it is too slow, since an eight to ten times stock turn is generally considered satisfactory in the retail dry goods field.
>
> Assuming, however, that this is a going concern, its liquidity at a given date is arrived at as follows: Considering the slow turnover of accounts receivable, this item, from a standpoint of current liquidity, is worth only about $60,000. Since its stock turn is only about six and one-half times a year and since the inventory has to be converted into accounts receivable first before any cash can be realized on it, this item is really not worth more than $25,000 from a standpoint of current liquidity. This gives a total of $89,500 of net current assets. If his monthly expenses amounting to $18,000 are added to his accounts payable of $60,000, and if it is assumed that at least a $2,000 instalment payment is due on his fixtures (as is apparently the case in view of the chattel mortgage item) it is found that his current assets exceed his current liabilities by only a small fraction. His furniture and fixture items from a standpoint of current liquidity, as well as his deferred current assets, can be discounted practically altogether, as they mean nothing from a standpoint of a going concern. If the bank loan was unsecured, it would be well to decline an extension of credit to this customer on the basis of the statement presented.

ASSETS		LIABILITIES	
Cash	$4,500.00	Owing:	
Accounts owing by customers	90,000.00	For merchandise on open account	$60,000.00
Merchandise	76,000.00	To bank	25,000.00
	$170,500.00	To friends, relatives and others	3,000.00
Prepaid rent and insurance	5,000.00	Chattel mortgage on fixtures	22,000.00
Cash surrender value of insurance	3,000.00		
Total deferred assets	$8,000.00		
Fixtures	55,000.00		
Less depreciation	3,000.00		
Total fixed assets	$52,000.00		
TOTAL ASSETS	$230,500.00	TOTAL LIABILITIES	$110,000.00
TOTAL ANNUAL SALES	$700,000.00		
TOTAL ANNUAL EXPENSES	$215,000.00		

ESTABLISHING CREDIT LIMITS

AFTER A DECISION has been reached that a customer is entitled to buy on credit terms, the credit executive must determine how much he may purchase. This investigation indicated that usually an effort is made to fix a limit within which a customer's credit purchases should be maintained. This action may be only informal, sometimes consisting of little more than a mental reservation on the part of the responsible executive, but other instances were found in which the practice of fixing fairly definite credit limits for customers was followed rather consistently. This seemed to be the case particularly among those companies with a large volume of small orders to handle, in which the credit approval function was organized somewhat on a routine basis in the interests of speed and economy. A company selling cotton thread to small dry goods stores throughout the country illustrates this policy.

The method of arriving at the amount of credit limits varies with individual companies. In most cases it was agreed, however, that the

FINANCIAL STATEMENT

OF _____

TO THE CONCERN NAMED ON ADDRESS SIDE OF THIS BLANK

For the purpose of obtaining merchandise from you on credit, we make the following statement in writing, intending that you should rely thereon respecting our financial condition as of (Date) _____

ASSETS	Dollars	Cents	LIABILITIES	Dollars	Cents
Cash on Hand			OWING FOR MERCHANDISE		
Cash in Bank			On Open Account, Notes or Acceptances not due		
Accounts Collectible			On Open Account, Notes or Acceptances past due		
Notes and Acceptances Collectible			OWING FOR BORROWED MONEY		
Merchandise ☐ At Market Value ☐ At Cost			To Bank		
Total Quick Assets			To Friends, Relatives and Others		
Machinery, Fixtures and Equipment (Present Value)			Liens or Chattel Mortgages on Merchandise and Equipment		
Real Estate			Mortgages on Real Estate		
Other Assets			Other Liabilities		
Total Assets			**Total Liabilities**		

Buy Goods from the Following Firms:

Name	Address	Owing

Annual Sales for Cash - - $_____ Insurance on Merchandise and Equipment - - - - $_____

Annual Sales on Credit - - $_____ Insurance on Real Estate - $_____

Total Annual Sales - - $_____ Life Insurance for benefit of the Company - - - - - $_____

Total Annual Expenses - $_____ Is any Insurance assigned?____ If so, what amount?_____

Title to Real Estate is in name of_____

Location and kind of business?_____ How long there?_____

What books of account do you keep?_____

Are your books of account audited?_____ If so, by whom?_____

When did you take last inventory?_____ Did you take inventory at cost or market price?_____

Does your inventory include merchandise on consignment or conditional sales?_____ If so, what amount? $_____

Do you hold any **merchandise** on consignment or conditional sale?_____ If so, what amount? $_____

Is any **machinery** or **equipment** held on conditional sale or lease?_____ Amount to be paid thereon $_____

What amount of your accounts, notes and acceptances are pledged or assigned? $_____

If any creditors are secured by Lien or Chattel Mortgages, state amounts and how secured_____

For what amounts are you liable as endorser, surety or guarantor? $_____

Name and address of your bank_____

The foregoing statement has been carefully read (both the printed and written matter), and is in all respects complete, accurate and truthful. It discloses to you the true state of my (our) financial condition on the_____day of_____19_____. Since that time there has been no material unfavorable change in my (our) financial condition; and if any such change takes place I (we) will give you notice. Until such notice is given, you are to regard this as a continuing statement.

Address_____ Town_____ State_____

Dated at_____ this_____ day of_____

(Name of Firm or Corporation)_____

Signed by_____

Form Stm. 102
THE WORKMAN MFG. CO., CHICAGO.

NO ENVELOPE IS REQUIRED

Just fold, stamp and mail

FINANCIAL STATEMENT FORM DEVELOPED BY NATIONAL ASSOCIATION OF CREDIT MEN

FIGURE III

NAME	DATE
CASH	A/Cs PAY
A/Cs	BANK–
FIXED	OTHER LIAB. –
LOANS	
DUE FROM CONTRACTORS–	
OTHER ASSETS–	
INVENTORY REQUIRED TO BE EVEN–	CAPITAL–
	SURPLUS–
INVENTORY (DATE)	NET SALES
NET PURCHASES	
LABOR	
EXPENSES	
INVENTORY REQUIRED TO BE EVEN	
COMMENTS–	

FORM OF STATEMENT ANALYSIS WORK SHEET

FIGURE IV

final decision depends largely on personal opinion and judgment. That this situation may be expected to produce widely different results in individual instances was demonstrated in a test conducted by fifteen experienced credit men. An actual case was selected for analysis and complete and identical information was furnished to each on which to determine the amount of credit to which the customer should be entitled. Only three of the fifteen agreed, each of these three arriving at the result through a different line of reasoning. The results secured by the other twelve participants were all different and varied widely. This experience indicates the difficulty of applying any standard formula or rule in determining credit limits.

A number of credit executives stressed the importance of the basic elements of character, capacity and capital in fixing credit limits. These they consider in every case. A representative of a large wholesale house takes into consideration, also, certain items included in the customer's financial statement, particularly the items of sales, expenses and inventories. Others emphasize the importance of a careful review of the ledger experience if such information is available. Other factors mentioned as bearing upon the decision to be made include general and local economic conditions and the general credit policy of the seller.

One credit man who is identified with a prominent house of commission merchants in New York, N. Y., summarized the factors considered by him in arriving at credit limits as follows:

1. The antecedents of the risk.
2. His own reactions, with particular reference to ability and character, as noted during a personal interview, whenever such interview is possible.
3. Information developed through a personal perusal of the customer's accounts receivable which gives him an indication of their liquidity and shows the type of trade sold.
4. Comparative operating statistics to show the trend of the customer's business.

On a particularly active account, this executive supplements the foregoing information with frequent reports from all the credit agencies operating in his field.

A prominent manufacturer of shirts follows the practice of limiting the amount of credit extended to a new customer on an initial order to an arbitrary amount for a probationary period of ninety days. At the end of this time each case is reviewed and, if the experience has been satisfactory, the limit is raised. Because of the seasonal nature of its business, this company has found it necessary to adopt a flexible policy, so that exceptional limits may be provided during the period prior to the Christmas season. A close check is kept on all accounts for which substantial credit limits have been established and, at the first indication that any such account is becoming slow, the case is investigated through a personal interview and a new limit is set if the evidence justifies it.

The extent to which the personality of the customer and the judgment of the credit appraiser enter into the determination of credit limits is illustrated by a case cited by a large factoring organization in the textile field. This company ordinarily follows a conservative policy in the extension of credit and fixing credit limits. However, in one instance, a company was granted a credit limit ranging from $10,000 to $12,000 on a financial statement that normally would have entitled it to only about a $2,000 limit. The larger amount was authorized largely on the strength of the reputation and standing of one of the principals of the customer's organization. This serves to illustrate clearly the difficulty of arriving at a credit limit on an arbitrary basis and the necessity for judging each case individually.

Apparently there is no satisfactory substitute for judgment in cases of this kind. This fact has been well stated by one credit executive as follows:

> You may have all the favorable facts and yet use poor judgment. Personally, in using my judgment every time a case comes up for decision, I take into consideration certain factors in about the following order of importance: (1) the facts before me; (2) the desire to increase sales and to keep losses at a minimum, and (3) the desire to build up the goodwill of my company.
>
> If I find that the facts do not warrant the line of credit under consideration, I may accept the risk nevertheless, and play along with the account, watching it closely until I have succeeded in getting the customer to discount regularly. On the other hand, I may reject the account solely on some personal basis although his financial statement may show him to be satisfactory.

Another experienced credit man has this to say:

> You take out the element of judgment in approving a credit risk, and you might as well do away with the credit department. It is the use of judgment that makes the credit manager a responsible executive in any business organization. This seems perfectly clear if one stops to consider some of the intangible phases which enter into a credit decision, such as appraising a customer's character, for instance.

In connection with the fixing of credit limits, it appears to some of the companies contacted during this investigation that the necessity for such action is minimized somewhat during a period of falling prices, when hand-to-mouth buying is practiced by a large number of customers. A number of these companies reported that, although they have established definite credit limits for their customers, few attempted to take advantage of their full credit line under conditions existing during 1931 and 1932.

TERMS OF SALE

ONE PHASE of credit management is concerned with the establishment and enforcement of terms of sale. From the credit standpoint, terms of sale involve net terms and generally some form of cash discount. In some industries, a policy of extra datings also may be in effect. Net terms are quoted to designate the definite credit period at the end of which full payment is required. A special discount for cash within a limited time has been used effectively by many business concerns as a means of expediting payment before the expiration of the regular credit period. A cash discount of this kind constitutes practically a premium for prompt payment and is usually quoted in conjunction with the net terms. The sale of such goods as straw hats, snow shovels and certain toys is subject to seasonal fluctuations. The manufacturers producing these goods may desire to operate their plants throughout the year, and therefore are willing to grant season datings, that is, they may make shipments in the Fall, for example, which are payable the following year any time from February 1st to July 1st.

Variation of Credit Terms

This investigation indicated a great variety of terms used, differing not only among various industries, but also within a single industry or trade, and even within an individual organization. The following table illustrates the variety of terms prevailing in different industries:

INDUSTRY	TERMS COMMONLY USED
Biscuits and Crackers	1/10, net /30
Buttons	1/10, net /30
Cardboard	3/10, net /30
Coal	½/10, net /30
Confectionery	1/10, or 2/10, net /30
Cotton Yarns	2/10 EOM, or 3/10, EOM, net /60
Drugs	1/10, 1/10 EOM, 2/10, 2/15, 2/30, net /30
Dry Goods Wholesale	2 or 3/10, 60 days extra, or 2/60, net /60 or 90
Flint and Lime Glass	1/15 days from receipt of shipment
Floor Covering	2/10, 3/30, 4/60, 4/70, 5/10
Foods	1/10, 2/10, net /30
Hardware	2/10, net /30 or 60
Knit Goods	1, 2 or 3/10, 1 or 2/30, net /60 or 70
Paint and Varnish	1, 2 or 2½/10, net /30 or 60
Publishing	2/10, 2/30, net /30
Shoes	No uniformity
Stationery	2/10, 2/10 EOM, 3/10, 2/30, net /30 or 60
Steel	½/10, net /30
Tobacco	2/10, net /30
Worsted Yarns	2/10, 60 days extra, 2/10 EOM, 3/10 EOM
Worsted Fabrics	2/10, 60 days extra, 3/30 EOM
Brass and Copper	1/10, net /30

Furthermore, a survey made by the Research Department of the National Association of Credit Men some time ago revealed the fact that, among twenty-six leading concerns in the knit goods industry, there were no less than seventeen different varieties of terms of sale, ranging from net 10 days 30

extra to 3 per cent 10 days, 2½ per cent 30 days, 2 per cent 60 days. In addition, one manufacturer of textiles interviewed during the course of this study used twenty-one different sets of terms based primarily on the type of commodity as well as the customer sold.

Generally speaking, this study revealed terms ranging from ten days to six months. The reasons underlying the length of terms vary according to the practices in different industries, the product sold, as well as the average stock turn involved. For instance, merchandise sold by a wholesaler to the retail trade usually is sold on short terms (for example, 2 per cent 10 days, net 30 days) if the retailer's stock turn is in the neighborhood of eight times a year. On the other hand, capital equipment, such as building material or elevators, often is sold on instalment terms, with a partial payment required with the order, another part payable upon delivery, and the balance to be paid at the completion of the installation. Again, some goods, like meats or other perishable products, are sold for payment within seven days because the goods are generally consumed during that period.

Meeting Cash Discount Abuses

From the table on page 15 it can be seen that the terms in many industries carry with them a cash discount privilege. As stated, this cash discount is offered as a premium for prompt payment and should be deducted only if remittance is made within the period specified. Frequently, however, a customer will attempt to deduct an unearned discount after the discount period has lapsed. During normal times, most of the credit executives interviewed report that they use every means at their disposal to correct this evil. In this connection a special investigation by this Bureau on the subject of cash discount practices conducted among six major industries, indicated that one of these methods usually is followed when unearned discounts are deducted:

1. Check accepted with unearned discount deducted; but the customer is notified that no such exception will be permitted in the future.
2. Check returned with an explanation of the reason. This method has been found particularly effective in the past but, if business conditions are depressed and collections slow, it is considered somewhat hazardous.
3. Check for the net amount accepted, but an additional check to cover the balance requested.

A CREDIT DEPARTMENT PROCEDURE

Credit policies and credit practices sometimes are described best in terms of specific applications. Therefore, a fairly detailed description of the procedure followed in conducting the credit and collection activities in one organization has been secured. This company is engaged in the manufacture of special machinery. Most of the orders handled are for equipment to be manufactured to the customer's specifications, requiring usually at least two weeks' time for production. As a result, the credit department may have more time for checking orders and investigating credits than would be the case in some other lines of industry. However, the methods followed may be of interest. The procedure followed is described here by the credit executive of this company.

Handling an Incoming Order

"When an order is received from a new customer, it is written up by our order department and assigned a number. The order is then referred to the credit department for terms. If the credit department can immediately decide from the rating in the agency book upon open terms, the order is stamped 'O.K.' and sent back to the order department. In this case, future orders, if approximately the same size as the initial order, are not taken up with the credit department, but are immediately put through for production. However, in the event that terms cannot be promptly decided upon, any order, whether initial or otherwise, is marked 'Call Credit.' When an order is marked other than 'O.K.,' the order department makes up what they

term a credit card on the customer placing the order. All future orders from that customer are taken up with the credit department before being accepted, unless the order department has been later informed that the customer in question is good for a certain amount of credit. In this case, the amount is written on the card and orders are not taken up with the credit department until their sum nears the limit established.

"Upon finding that a customer's account has become seriously delinquent or that he has made unjust claims, a memorandum is written by the credit department to the order department withdrawing the customer's credit. The latter makes up the usual credit card, and unless advised otherwise, refers all future orders from this customer to the credit department for terms. In this way, all new and doubtful accounts have the attention of the credit department.

Routine of Checking Credits

"When an initial order is referred to the credit department, the first step is to look up the customer's rating in the agency books. Whether or not the rating is such that we feel secure in accepting the first order on open terms without making a further investigation, we send for an agency report. Then, in the event the customer wants additional credit before the first order is due for payment, we can determine if he is a safe risk for the total amount involved.

"If a customer is not listed in the agency book, we know that the agency does not know a great deal about him, or that he is so small that there can be no cause for objection if the first shipment goes forward C.O.D. Consequently, we mail the customer a form letter thanking him for the order and explaining that it will be shipped C.O.D. or S.D.B.L. (Sight Draft Attached to Bill of Lading), as the case may be. Also, we ask for the usual bank and trade references. If the customer is worthy of open terms and wants them, he usually responds, giving us the references requested, whereupon we make the usual investigation, allowing terms accordingly.

"The customer's financial standing is briefly kept on a visible record card file, giving information concerning terms, financial responsibility, manner of payment, limit of credit extended, and up-to-date agency ratings. Where credit is very limited, a pencil memorandum is made on these cards of the value of incoming orders. The memoranda are erased as soon as shipment is made.

"We have approximately 1,500 accounts open on our books each month. Duplicate statements in loose-leaf books are given to the credit department monthly, the paid statements having been taken out or the paid items marked Paid, with the unpaid remaining open, as the case may be. All cash is posted daily against the statements in question before being turned over to the bookkeeping department. Thus, the credit and collection department has an up-to-date record showing the condition of each account, which record is principally used for following up collections.

"The statements are used as a credit facility also, in conjunction with the customers' financial standing cards, to determine whether or not accounts have reached their limit. This is done by adding the amount shown as open on the statement to the amount of the current incoming orders shown on the customers' financial standing cards.

"By use of the two records under discussion, it is easy to determine quickly and accurately what terms should be applied on doubtful orders which are referred to the credit department.

"In our organization there are several branches and, of course, slip-ups are bound to occur now and then. To catch and correct these slip-ups, we have daily reports of orders received from each of the plants, copies of which are sent to both our treasurer and assistant treasurer. These two officials also have a monthly accounts receivable report which lists all delinquent accounts. By checking the daily order report against the monthly accounts receivable report, the treasurer has an accurate knowledge of how credits and collections are being handled.

"It falls to the lot of the assistant treasurer, however, to make a closer check-up. He goes over the daily order reports each day, checking all customers that he does not know are

safe risks for the amounts they have ordered. The assistant treasurer also has at his disposal a copy of the monthly delinquent accounts receivable report, which shows in three columns all accounts that are sixty, ninety or more days past due, and the total amounts they owe. It also states the months in which the invoices were issued. While checking the daily order reports, he checks the customers who have allowed their accounts to become delinquent, and jots down on the reports the amounts they owe and the months in which the invoices were issued.

"He then turns the daily order reports over to a clerk who gets from the file the financial standing cards on all names that are checked, attaching them to their respective sheets of the report and turning them over to him. Where the names were checked because of delinquent accounts, the customers' financial standing cards afford the means of deciding whether or not customers' credit should be withdrawn until their old obligations are paid. There are always names of companies checked on the report whose accounts are not delinquent but whose credit standing is unknown to the assistant treasurer. By reviewing the customers' financial standing cards, he can determine whether or not the terms already applied are agreeable. We should mention here that special terms are shown on this daily order report."

EFFECTING COLLECTIONS

A VARIETY OF METHODS are employed for making collections. Inquiry on this subject has indicated that the most effective method in individual cases is governed by a number of considerations varying in different companies. These include such factors as the number and type of customers served, the degree of concentration or accessibility of the trade, uniform policies and practices in effect within an industry, and the personality of the credit or collection executive. Generally, however, it appears that most of the business concerns contributing to this report undertake to effect their collections through one or more of the following methods:

1. Special terms or discounts as a premium for prompt payment
2. System of dunning or solicitation conducted either
   (*a*) by mail,
   (*b*) by telegraph or telephone,
   (*c*) by personal collectors
3. Use of outside collection agencies
4. Legal action

The Cash Discount as a Collection Tool

The offering of a special discount for cash is one of the methods most frequently employed for expediting collections. A Buffalo concern manufacturing chemicals has found it profitable to encourage the practice of discounting bills among its customers by pointing out the extraordinary savings which can be effected in this manner. Some have found that the significance of the cash discount best can be appreciated if stated in terms of the equivalent rate of interest per annum. This is determined readily by computing the number of days intervening between the optional dates of payment and dividing this into 360 to determine the proportionate part of a year represented. The cash discount rate is then multiplied by this figure to secure the equivalent annual interest rate. To illustrate this, it may be assumed that a bill of goods is purchased on October 1st at terms of 5 per cent 30 days, net 60. The bill may be paid on October 30th and the 5 per cent discount taken by the buyer, or a remittance may be made at the end of the following month, the date when the account is due, net. If the latter option is exercised, the customer indirectly pays 5 per cent for the use of the money represented by the amount of the bill for 30 days—the intervening period between the two optional dates of payment. The equivalent rate of interest per annum is, therefore, twelve times 5 per cent, or 60 per cent. The table on page 19 shows the savings effected under the more commonly used discount terms when computed in this manner.

2%	10 days—net 30 days	=	36% per annum
3%	10 days—net 4 months	=	10% per annum
3%	20 days—net 60 days	=	36% per annum
3%	10 days—net 30 days	=	54% per annum
4%	10 days—net 4 months	=	13% per annum
4%	10 days—net 60 days	=	29% per annum
5%	10 days—net 4 months	=	16% per annum
5%	10 days—net 60 days	=	36% per annum
5%	10 days—net 30 days	=	90% per annum
6%	10 days—net 4 months	=	20% per annum
6%	10 days—net 60 days	=	43% per annum
7%	10 days—net 4 months	=	23% per annum
8%	10 days—net 4 months	=	26% per annum

The experience of credit executives has indicated that the savings as shown in the above table serve as a definite inducement for the expediting of payment by most customers. In fact, some firms report that they are so thoroughly convinced of this fact that they consider the failure to take advantage of the discounts offered as an indication of weakness. In the grocery field, for example, operating margins are such that, in some cases, earnings made through the discounting of purchases constitute practically the net profit of the business. An executive prominently identified with the wholesale grocery trade has stated that, in view of this condition, he considers any retail grocer who fails to discount his bills a doubtful credit risk.

Dunning Systems

One alternative method employed for effecting collections is through some form of a dunning system, which usually is put into operation more or less automatically for all accounts failing to take advantage of the discount privilege. In this way, an effort is made to forestall, or at least minimize, any possible chance of an account becoming past due.

Investigation has indicated that by far the largest proportion of collections in industry are made by correspondence. This certainly is true of those companies with which this Bureau has come in contact in the course of its investigations. However, the actual form in which this type of collection activity is carried on varies. Apparently, the use of a formal statement of the account sent out at periodical intervals is becoming more frequent among some of the larger manufacturers and wholesalers. Sometimes special stickers or rubber stamp impressions on the statement form are employed to attract attention to past due items, without the necessity for a special letter on the subject. Usually, however, one or more collection letters or notices form a part of the collection procedures reviewed. In many organizations these are quite standardized as to form and are sent out in accordance with a rather definite schedule. However, in the opinion of some credit executives, form letters have been used to excess in collection correspondence and they are inclined to favor an individually written letter designed to meet more specifically the special conditions in each individual case. The treasurer of a well-known textile company, for instance, reported that his company had discontinued the use of form letters for collection purposes several years ago, since their experience had shown that such letters did not accomplish the desired results.

With this change in the type of collection correspondence which has taken place in some companies, there has occurred a noticeable change in the type of personnel engaged in collection activities. In many organizations, well qualified correspondents have replaced clerks who formerly handled this work in a routine manner, with a generally higher level of collection efficiency resulting. This question of collection correspondence has been the subject of previous investigations by the Policyholders Service Bureau and two special reports are available as a result. One is entitled *Effective Collection Letters Used by Manufacturers and Wholesalers* and the other, *Collection Letters Used by Retailers*.

Normally, a dunning system has two objectives. The primary purpose is to secure immediate payment. However, if a customer is unable to remit for some reason, there is the secondary objective of securing a response and an explanation of the delay or delinquency. If payment is withheld through some cause beyond the control of the customer, many experienced credit men are willing to show him a reasonable amount of leniency. For instance, in some cases, he may be permitted to liquidate his indebtedness by making an initial payment and covering the balance by a series of notes at certain intervals over a

somewhat longer period of time. In this way the customer is given a chance to work himself out of his financial straits. Many companies testify to the value of a collection policy that is sufficiently flexible to permit the handling of such cases on their individual merits.

CONTROLLING CREDIT AND COLLECTION ACTIVITIES

AN IMPORTANT PHASE of credit management is the development of an adequate current control over all credit and collection activities. Some practical measure or gauge of the efficiency with which the work of the credit department is conducted has been found valuable as an initial step in this direction. Among the devices used effectively for this purpose are statistical data compiled either internally or compositely by trades or areas for such items as (*a*) bad debt losses, (*b*) business failures, (*c*) various analyses of accounts, (*d*) collection percentages, and (*e*) the turnover of accounts receivable.

Bad Debt Loss Ratios

A comparison of the bad debt loss experience of a company with the average experience for the trade or industry concerned provides one practical test of the credit policies in effect. These are usually stated in terms of the ratio of such losses to total net sales. Average bad debt loss ratios of this kind have been compiled by the National Association of Credit Men for a number of trades and industries. Operating ratio studies conducted cooperatively within an industry by a number of trade associations and research organizations identified with some of the large universities also include information on this point. Information of this kind has been published at one time or another for various industries such as the automotive, drug, electrical, furniture, grocery, hardware, ice-cream, paint, plumbing and heating, and printing.

Many credit managers make a practice of compiling this information currently for their own organizations for the purpose of comparing the experience from year to year and interpreting the results in relation to changing business conditions.

Business Failure Statistics

In the opinion of many credit executives, statistics on business failures have not been available in sufficient detail to be of very practical assistance as a credit gauge. Until recently, little breakdown of this experience has been attempted on other than very broad industrial lines. Published statistics on this subject as a rule report only the number of failures and the amount of liabilities involved. Recently, one of the large mercantile agencies has undertaken to develop business failure statistics along more comprehensive lines. Under the plan in process, a monthly analysis of business failures will be available (*a*) by type of organization, such as manufacturer, wholesaler or retailer, (*b*) by location, such as Federal Reserve Districts and (*c*) by trade or industry. The classifications in this last group will be shown first by major industrial groupings and then subdivided in considerable detail according to the subordinate divisions of each industry. With these facts available to reflect conditions in various trades and various localities, those responsible for this activity are of the opinion that credit executives will be in a position to adjust credit policies to meet changing conditions and to avoid many future difficulties.

Classification of Overdue Accounts

As a means of facilitating the prompt collection of outstanding accounts and the maintenance of a satisfactory turnover of accounts receivable, most of the companies covered in this investigation follow the practice of furnishing the credit manager with an analysis of all accounts receivable which are outstanding at the end of each month. This is usually available not later than the tenth of the following month and furnishes a means of controlling the operations of the collection department and also of interpreting collection conditions in comparison with any seasonal characteristics of the business. This analysis usually takes the following form:

1. By age
   - (*a*) Under 30 days,
   - (*b*) Thirty to 60 days,
   - (*c*) Sixty to 90 days,
   - (*d*) Ninety days and over.
2. By salesman or territory, *to bring out any sectional characteristics from the collection standpoint.*
3. By the major classifications of products, *in order to determine the relative difficulty of each in effecting collections.*
4. By types of customers

Frequently such an analysis will be the means of bringing certain facts to the attention of the credit manager which will be helpful to him in adapting his collection methods to meet these conditions.

Collection Statistics

Internal control of collections is reported to be facilitated by some companies through the development of current statistics on collection ratios and accounts receivable turnover for individual companies. The collection ratio is calculated usually on a monthly basis by dividing the actual collections during the month by the total receivables outstanding at the first of the month. This percentage then is compared from month to month and from year to year, with proper allowance being made for seasonal fluctuations. Accounts receivable turnover figures give a similar index of collection efficiency. This information usually is stated in one of two ways, either as a turnover figure, determined by dividing the average amount of accounts receivable outstanding into total sales for the period, usually a year, or as the average number of days accounts are outstanding. This latter figure is secured by dividing the turnover figure mentioned above into 365. This result then is compared with the company's terms of payment to ascertain the extent to which those terms are being enforced.

Scheduling Collections

As a means of maintaining current control over collection activities, one credit executive in the textile field selling to the retail dry goods trade carefully schedules his collection program one month in advance. The total amount to be collected during the month is determined and this is scheduled to show the proportion of the total that should be collected by certain dates. To illustrate this program, assume that the credit sales during the month of March totaled $400,000, of which $75,000 represented shipments made after the 25th of March and before the first of April. After deducting the $75,000 which is not payable until May 1st under the terms of sale in effect in this industry, the total amount due on April 1st is $325,000. This amount would be scheduled for collection during April as follows:

Of the total amount owing for the month,
50 per cent., or $162,500, must be collected by April 15th.

75 per cent., or $243,750, must be collected by April 22d.

100 per cent., or $325,000, must be collected by April 30th.

If a check-up on April 22d shows the collections running behind the schedule, greater emphasis is put on the collection efforts for the balance of the month, in order to make up this deficiency. This company reports that actual collections conform so closely to this schedule as a rule, that a collection turnover on a 30-day basis, or 12 times a year, is practically attained.

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OTHER REPORTS prepared by the Policyholders Service Bureau on credit and collection subjects are listed below.

Reports marked with an asterisk were prepared to answer specific questions raised by a Group insurance policyholder and are not necessarily all-inclusive discussions of the indicated subjects. Copies of any of these publications can be secured on request:

A Bank Collection Department Procedure

**Cash Discount Practices in Connection with Notes and Acceptances in the Jewelry Field*

**Collection Letters Used by Retailers*

Consider the Approach—A Series of Collection Letters

**Credit and Collection Practices in the Dress Manufacturing Field*

**Credit and Collection Practices of Hospitals*

**Effective Collection Letters Used by Manufacturers and Wholesalers*

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